

May 4, 1988

LETTER 990

Apr 22 DJIA 2015.09; PTI 2693; A-D Ratio -9.03
Apr 29 DJIA 2032.33; PTI 2703; A-D Ratio -8.76
Current Dow Yield: 3.45%; Dow P/E: 15.2
Dow 200-day mov aver: 2165; DowPow: 761

NEWS: I don't usually deal with coming news events on this page, but here goes. According to *C.J. Lawrence's* Ed Hyman the Texas mess is shaping up as "the biggest banking crisis in history." Hyman believes the Texas banks are losing \$1 billion a week in deposits. He also expects the Texas bank bailout to reach \$8 billion, and that does not include the Texas S&Ls, half of which are in severe trouble. It shapes up as the biggest, costliest banking bust in US history -- and it will add to the US deficit.

PRICE ACTION: The great 1974 to 1987 bull market topped out as follows: D-J Utilities at 227.83 on January 25, 1987. The D-J Transports at 1101.16 on August 14. The D-J Industrials at 2722.42 on August 25. On October 15 the Averages (via Dow Theory) signaled a primary bear market. On October 19 history's greatest crash occurred.

Following the crash, the market embarked on a typical post-crash recovery rally. In the last Letter I listed the post-crash high points for the D-J Averages. I further stated that when the primary trend is down (as it now is) I always give the bear the benefit of the doubt. For that reason, my policy is to treat every reversal and every unconfirmed high in the Averages as a potential important top.

Therefore, until proved otherwise, I suggest we designate the following points as being important reversal points or tops for the post-crash rally. For the Utilities we had a high back on January 29 (1988) at 190.02. The Transports recorded their post-crash high of 904.12 on March 23. Finally, the Dow recorded its post-crash high of 2110.08 on April 12.

Today many analysts are reporting that "business continues good" and therefore "there is no reason for the stock market to go down." Of course, this approach is absurd on the face of it. These analysts forget that current business statistics (which are always history) don't forecast the future trend of the stock market; rather it is the stock market which discounts (and therefore forecasts) the future trend of business.

Since the primary trend of the market is down and since the post-crash rally could have ended, my opinion is that we are probably seeing the best of 1987's business conditions right now. I would guess that by 1988 we will be looking at a much less rosy business picture.

Stocks: Each week I grade each of the 30 Dow Industrials stocks as to strength (based strictly on market action). To be strong I require that a stock (1) act better than the market on a relative strength basis and (2) be above its own average price of the past 30 weeks (i.e., hold above its own 30-week moving average). On this basis only 7 of the 30 Dow Industrials pass the strength test. They are Bethlehem Steel, Chevron, Exxon, Goodyear, Int. Paper, USX, Woolworth. One stock, Merck, is on the borderline. So 23% of the Dow Industrial stocks are strong -- a fairly typical bear market percentage.

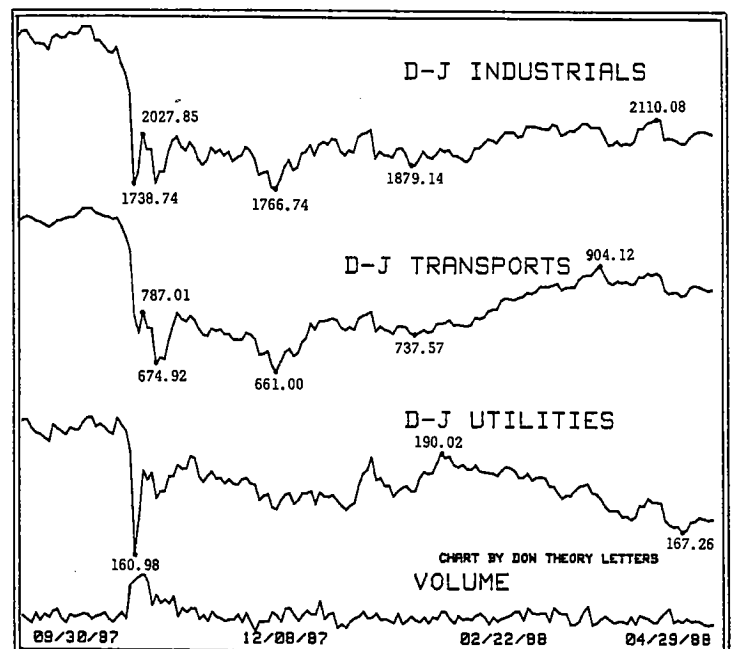
INTERNATIONAL: From the April 18 *London Financial Times*: "The speed with which Japan has dominated global markets has been one of the most remarkable features of the six months since the stock markets' crash. Japan overtook the US in terms of market capitalization just before the crash. Its subsequent weighting in the World Index had risen to more than 43% by the end of last week, from 37% on October 16. In contrast, the other principal markets

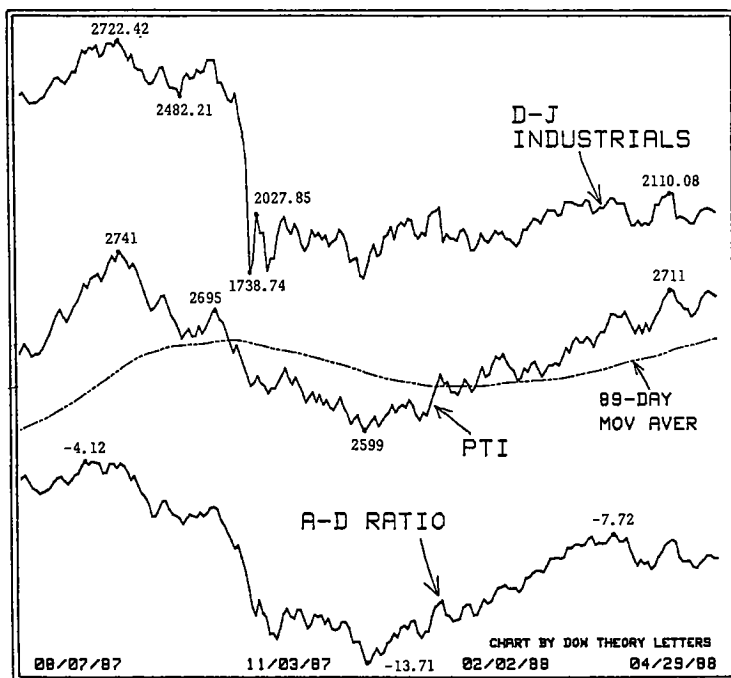
have all lost ground. The US has seen its share of global capitalization fall from 34% on Oct. 16 to 32%, while the UK has dropped from nearly 11% to 9.4%, W. Germany from 3.4% to 2.8% and Canada from 2.14% to 2.07%."

THE PICTURE: The newspapers, TV, and the media in general are filled with the latest statistics on unemployment, factory capacity, the Fed's intentions, industrial production, inventory/sales ratios, etc. The belief is that somehow if the economic statistics improve enough, this will indicate that we're back in a bull market.

Sadly, I must report that it's not going to work that way. Today's economic statistics are about as good or better as they were last August, and the Dow is still 600 points under those August highs. My opinion is that the stock market is looking past all the current rosy and semi-rosy economic statistics -- toward trouble later in the year or after the election. For most investors that's hard to believe. The average person simply cannot accept the thesis that once the primary trend of the market turns down, the best is over and the big picture ahead is fated to be deterioration in the economy and a long-term trend of lower stock prices. But that's the way it is, and that's the meaning of the Dow Theory bear signal of October 15. I know it's hard to accept, but I'll keep writing about it anyway.

A lot is being made of the presumed "pessimism and gloom that has now overtaken the investing public." Bulls are saying that this can't be a bear market (contrary opinion) because there's just too much hand-wringing and anxiety at this time. I have a few comments to make on the subject.





First, most of the men and women writing advisory reports today have never lived through a big bear market. So I take their observations about "all this bearishness" with a grain of salt. The fact is that in a big bear market (particularly one that starts with an historic crash) you are going to get a lot of pessimism. And you're going to continue to get it in varying quantities throughout the length of the bear market. Let's face it -- a bunch of people were both frightened and hurt by the crash. And they haven't exactly been cleaning up in the market since. So investors today are bound to be a bit skeptical, and a wee bit unhappy. It's normal; it's human nature.

As this bear market progresses we're going to see more unhappiness, more pessimism. But that in itself will not end the bear market. What I believe has happened so far (in this first phase of the bear market) is that a great many people have stopped buying stocks. They've stopped buying, but they have not really started to sell. There are still millions of stockholders and millions of mutual fund holders out there. These people may have pulled in their horns on the buy side, but they are not selling yet. To me that means that investors are unhappy but still hopeful.

To really give up on the stock market means to sell out -- to sell out at prevailing prices, to sell out at whatever the market will bear. We haven't seen that kind of action yet, not by a long shot. That kind of selling comes only in the third and final phase of a bear market.

So what I'm saying is -- you can expect continuing pessimism throughout the length of this bear market. But distress selling, black gloom, empty boardrooms, volume of 20 to 30 million shares a day -- we haven't seen that yet; we're just not near that kind of sentiment yet.

A number of people walk up to me and announce that they're "bullish on America." I tell them that's fine, that's a great attitude. But I tell them, don't confuse your love for America with the markets. It makes as much sense to have told me a few years ago that you were proud of the reserve status of the dollar. As an attitude, being proud of the Yankee dollar or being bullish on America is fine. As an approach to the stock market or the bond or money markets, it's an absolutely meaningless statement.

So what do I think? The more I study this whole situation, the more I look at the action of the market and the whole economic picture, the more I believe we are going to have to deal with a devilishly

difficult bear market. The world isn't simple anymore. And the American condition and America's future isn't clear any more.

Today we're the world's leading debtor nation with a reserve currency that's been badly battered. We're a nation that is piling up debt at an absolutely unsustainable rate. We're a nation that is living far, far beyond our means. We're a nation with a high standard of living but one that is dependent on foreigners buying and holding our endless debt issues. We're a nation living in an economic environment which is competitive to a degree never before experienced by American industry and American workers.

My instinct (and my instinct hasn't been too bad over the years) tells me that this bear market is going to be a deceptive one, a complex one, a difficult one and very probably a long one. It's a bear market that I feel has a massive, maybe shocking, downside potential. If you don't believe that, go back to the last Letter and re-study that chart of the PTI on page 3. That chart alone is enough to make one lose sleep.

What I like least about the current situation as this bear market mills about in its first phase is the debt situation. To put it mildly, debt in the US is out of control. Corporate debt, for instance, has climbed from the \$20 billion area of the early 1980s to a January 1988 figure of \$127 billion. Interest costs now consume 50% of all corporate pre-tax profits (it used to be 10%). Furthermore, the total debt of this nation has been climbing astronomically. In the fourth quarter of 1987 alone, total debt in the US climbed at the rate of \$100 billion a month! The fact is this nation has gone absolutely crazy with debt.

If I had to predict here and now what this bear market will be about I'd put it in a single phrase -- debt liquidation. I think the era ahead is going to be labeled as the "unwinding of America," the "era of unravelling debt."

It took roughly 40 years to pile up the mountains of debt which we are wallowing in (and still creating). Therefore, I don't think the debt situation will unwind in a hurry. But I believe that thinking and attitudes in this nation are going to be changed by the great debt liquidation that I see ahead. I believe that before this bear market is over, debt is going to be a dirty word. And I think that once this bear market gets in full gear on the downside, we will experience an extended period in which people and states and the federal government struggle to liquidate and pare down their debts.

My feeling about the crash of '87 is that it was the market's way of saying, "the US debt mountain is out of control, it's unsustainable, and we're very close to trouble. In view of that, stocks are way too high."

That, in a nutshell, is what I think the crash was all about. The crash itself amounted to "instant adjustment" on the market's part. Why did the market pick October 19 to begin its "adjusting?" I don't know. Why did the Dow pick December 6, 1974 to bottom out? Why did the Dow pick September 3, 1929 to top out? No one knows. Those dates are part of the great and unfathomable mysteries of Wall Street.

A potential crisis: This nation has been depending on Japan to purchase roughly one-third of its new debt each year. The Japanese have been patiently buying that debt, but always, I believe, with the thought that in due time the US would move toward balancing its federal budget. It's increasingly apparent to me (and it must be to the Japanese) that the budget isn't even beginning to be balanced.

Statistics and opinions that I have recently seen indicate that the Japanese are now cutting back on their purchase of US Treasury debt. Some Japanese money is being diverted toward the British pound, and a good deal of Japanese money is going into direct investments in US property and business. This will mean less Japanese buying of US debt. One result will be that the Fed will be forced to make up the shortfall by buying Treasury debt. When the Fed buys Treasury debt such action is inflationary. Inflation brings on higher interest rates.

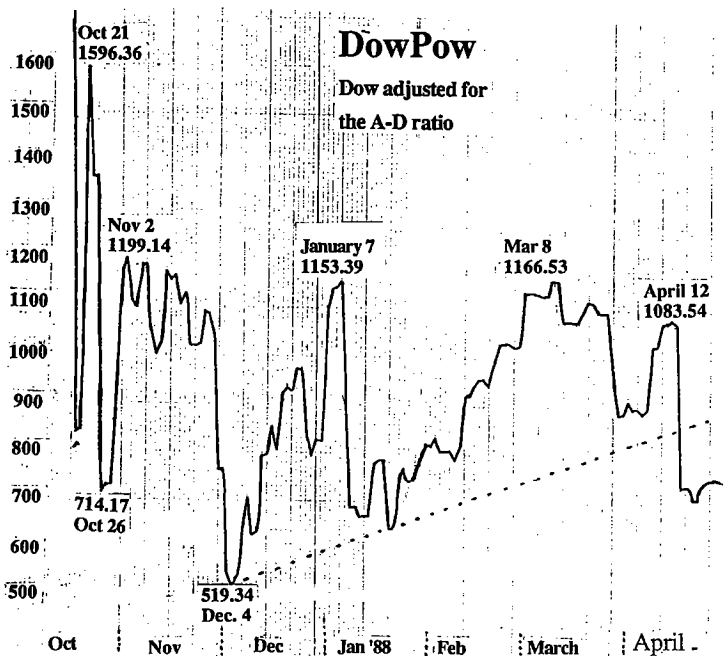
INVESTMENT POSITION: The bear is ruler of the box. Many of the longer-term Treasury bonds went over the 9.15% level a few weeks ago, which is in rather stark contrast to the current 3.47% offered by the D-J Industrial Average. With roughly a 5.7% yield advantage in favor of bonds, it takes a truly optimistic stance on stocks to be a buyer in today's market. Furthermore, this market is extremely interest-rate sensitive, and any forthcoming rise in interest rates will put immediate pressure on the stock market. Thus to a degree seldom seen, the bond market is running the show on Wall Street.



As far as we're concerned, the Dow Theory on October 15 handed down its verdict. The verdict was and still is that it's a bear market. In a bear market it's a long-term losing proposition to hold stocks. Thus our investment stance continues to be -- on the sidelines.

DOWPOW: Some observers are dubbing this the "maddening market" because it has plenty of volatility but never seems to get anywhere. Perhaps this can best be seen in the action of the PTI and DowPow. The PTI has been in a gradual rising trend ever since December 4 (see page 2 chart). Despite this, DowPow is still nearer the low than the high.

Frankly, I've never seen anything quite like it, but there's no denying what my indicators are saying. They're saying that since December 4 the secondary trend of the market has been UP but that it's been a very WEAK trend, so weak that DowPow (incredibly) has made little or no progress on the upside (historically, the profitable rises occur when DowPow heads up in earnest).



QUESTIONS, ANSWERS: Question: Russell, how is it that you don't have a hot line?

Answer: I have always felt that a hot line puts the market on the basis of daily action. I don't advocate in-and-out trading, and I just never wanted to get into the daily advice routine. The important turns in the market don't take place in a day, and there is usually plenty of time to see the turns coming. I prefer to lay out the important points and implications ahead of time for subscribers. Then if the market does what I think it "should" or "should not" do, subscribers will be prepared for it. To put it in a nutshell, I never thought a hot line was necessary (for example, we certainly

didn't need a hot line to avoid the 1987 crash, whereas most services never saw the bear market coming and never got their subscribers out of the market before the crash, hot line or no hot line).

Question: It seems to me that you are very conservative, maybe too conservative. Why don't you advocate more trading in this market?

Answer: I feel that I offer a lot of information in each report. If any given subscriber wants to trade in this market I have no objection. In fact, many subscribers use my PTI for just that purpose -- trading for the bull side when the PTI is above its moving average and the opposite when the PTI is below its MA.

However, I've stated many times before that in my over 40 years of experience in this business I have found that most investors tend to make money in a bull market if they will simply invest and sit. Most investors tend to lose money in a bear market, unless they stay out and in cash. It is said that "a second marriage is a triumph of hope over experience." I see buying and trading stocks in a bear market in the same light.

By the way, a few of the major so-called mutual fund "switch services" just got whipsawed when this market crossed them up on their moving averages. Two or three 5% to 10% whipsaws and you're talking about some expensive losses.

Question: Russell, what do you make of all these comparisons of 1987-88 with 1929-30? You've made such a comparison yourself.

Answer: Comparisons of the two periods so far have been rather eerie. But that's really all I make of it. No two bear markets will ever be exactly alike, even if they start looking alike. A number of commentators have noted that the two periods are immediately different because the economy was falling apart in 1930 whereas the economy is intact today. That's true, but I want to remind readers again that the stock market forecasts the economy and not vice versa.

Thus, the crash of 1987 is telling me that very difficult times lie ahead. How those difficulties unfold and what they will be cannot be known at this time. The fooler so far in 1987-88 is that the economy has held up so well after the market crash -- and that it could hold up until well after the election. The fooler in 1929-30 was that the trouble was fated to be so severe (i.e., an ultimate 89% drop in the Dow and the worst depression in US history).

Question: If this is a bear market and the primary trend is down, how is it that seven months have passed and the Dow is still well above its crash low of 1738.74?

Answer: the market doesn't perform for you or me, it marches to its own tune and in its own good time. An old Wall Street adage states that "the market always does what it's supposed to -- but never when." I do believe, however, that it's only a matter of time before the Dow 1738.74 level is broken. Referring to 1929 again, the 1929 crash low of 198.69 was recorded on November 13. Most people don't realize it but it wasn't until October 17, 1930, almost a year later, that the 1929 crash lows were broken. If 1929 was to repeat exactly (which probably won't happen), the October 1987 crash lows would obviously not be violated until September.

Question: Russell, everyone seems to be waiting for trouble to hit the Japanese market, following which the US market is supposed to fall apart. What do you think of this thesis?

Answer: As a rule, the strongest market tops out last and bottoms out first. Thus, in the past the British market (which used to be the weaker market compared with the US market) would top out before the the US market, but the US market would bottom out before the British market.

As I see it, international positions have changed. The US and Japan are now the big markets. At the primary peak the US market will top out before the Japanese market (this has already occurred), while at the bear market bottom the Japanese market will turn up

first. My guess: Japan will fall apart only after the post-crash rally in the US market dies, and the US market heads down in earnest.

Question: Do you think there could be another stock market crash?

Answer: I honestly don't know. The Exchange thinks that it may have crash-proofed the market, but I don't believe that for a second. Certainly, in my opinion, the recent limits placed on program trading will not prevent a crash. If people want to sell their stocks, nothing in the world is going to stop them. If the market panics and the governors close the Exchange, it will simply be that much worse when the Exchange is opened again. Closing the Exchange destroys liquidity, and destroying liquidity obviously makes things worse.

This is a bear market, and in a bear market values diminish through time (just as in a bull market values increase through time). Thus, the longer the market fluctuates above the crash lows, the greater the chances of another crash (since the higher the post-crash rise, the higher stocks have pushed above their true bear market values).

Question: What do you think of last week's Supreme Court decision stating that the government had a Constitutional right (if it so wishes) to tax municipal bonds?

Answer: This ruling came up in response to a S. Carolina challenge (based on the 10th Amendment) to the 1982 law which made registration of all new muni bonds mandatory. In rejecting the S. Carolina argument, the Court said that the Constitution does not protect the interest from state-issued bonds from government taxation. In other words, the Court was saying, in effect, "Forget about registration. You don't even have a Constitutional right to federal tax exemption."

Will this ruling mean that the feds will tax muni bonds? In my opinion, no. Taxing muni interest would cost the states, counties, and cities a fortune. Furthermore, the states could retaliate by taxing federal debt. No, I think muni tax exempt interest is safe. Attacking it would release an unbelievable can of worms

Question: Russell, you tell us that this is a going to be a long primary bear market. In view of that, where is the safest place to have our assets?

Answer: This is a very difficult question. In the Great Depression of the '30s, this question was easily answered. You kept your assets in the "almighty dollar." Nobody in '32 or '35 or '42 doubted the value or stability of dollars. The real problem was how to get hold of a few dollars.

Today, it's a different story. As I see it, there is no guaranteed island of safety today comparable to the dollar in the 1930s. Today, every item is suspect. The dollar itself could become suspect (or I should say even more suspect). Gold could cave in during a deflation as could stocks or bonds. Real estate could collapse during a severe recession. If we get a liquidity squeeze, bonds and stocks could tumble as could gold. Nobody knows how the foreign currencies would act during a world depression.

What's the answer? There's nothing even close to a perfect answer so I opt for diversification with the caveat that "in a major bear market the person who loses the least is the winner." What to diversify into? I suggest T-bills, a government-securities-only money market fund, some gold, maybe some bonds, hold onto your home, and pay off your debt.

Question: Russell, what do you make of the current frenzy in the collectibles, art, precious stones, and auction markets? In the Warhol auction last week, for instance, items went for double or more what experts thought they would go for? What's happening?

Answer: In my opinion, the booming price of "things" has been brought on by a number of factors. (1) The continuation of the US

trade and budget deficits which has led to the collapse of the dollar -- and therefore to domestic and international distrust of the dollar. (2) The extraordinary industry of the Japanese plus the massive savings and liquidity of the Japanese. The collapsed dollar has caused all things American to appear dirt cheap to the Japanese. This plus Japan's bulging coffers have allowed the Japanese to go out and "buy up America and the world." (3) The acceptance of leverage ("junk bonds") plus the buyout and acquisition mania has led to a "buy it at any price" syndrome. Big money is on the move. It's restless. And today's heroes are Campeau, cover-boy Donald Trump, and the storied Bass brothers.

Rising prices in the face of the suspect dollar has become infectious. "Big money," worried about the dollar and the future of the world's banking and financial systems, is now diversifying. The wealthy are diversifying into items that have a history of holding their value, and I'm talking about major art works, diamonds and outstanding colored stones, important collectibles, fine coins, great homes, etc.

The fact is that a great amount of individual wealth (leveraged or not, borrowed or not) was generated in the bull market of 1974 to 1987. This wealth is now looking for places to go. Much of it is going into "things." The bear market may or may not ultimately destroy much of this wealth. No one knows. But this money must go somewhere. At this stage of the game, it is diversifying. Van Goghs in the \$50 million range and diamonds in the \$1 to \$9 million dollar range are a visible testament to what's happening.

INVESTING: A brilliant investor friend of mine (he's made millions) told me many years ago, "Forget timing, just give me time." This fellow was a compounder, a man who knew that assets compound and increase through time.

I learned that lesson on my own, and I learned it early. I learned it from the final article written by the financial editor of the old *New York Herald Tribune* (this was the last article the editor wrote before retiring). The editor wrote that, financially, young people make a great mistake. They get married, buy a house and furniture, and thereupon immediately go heavily into debt. Then they spend the rest of their lives paying off the debt while going into additional debt.

The intelligent thing to do, stated this editor, is to start saving when you are young. Thus, you will have time and compounding working for you -- rather than against you. I won't go into all my compounding statistics at this point, but I will offer one example: Put \$5,000 a year into high-grade tax-free muni bonds yielding 7% (actually you can get 7.5% today on AA-rated munis), and in 20 years you'll have \$205,000.

There are two items to remember in the above equation. The first is that you must buy high-grade bonds, bonds that are not going to default. That's important. You're not going to make money if you accumulate and compound bankruptcies.

The second thing to remember is that interest rates will fluctuate, but over the years the odds are that they will rise on average. So you've got to continue buying. You must stay with your program. You can't stop because the market declined or because you're next-door neighbor told you that bonds are going out of style.

Now ANY OTHER FORM of INVESTING (and very few people realize this) is an attempt to BEAT TIME. In other words, any method such as buying stocks or bonds in bull markets and selling out in bear markets, or trading on the basis of buying undervalued stocks and selling when they become overvalued or any other method is in reality an effort to beat the compounding process. In attempting to speed up the mathematic certainty of compounding you are saying, "I'm not going to go the boring compounding-through-time route -- I'm going to beat time with shrewd buying and selling."

Now I'm not saying this can't be done. Thousands of investors have done it -- and are doing it. But I am saying that in my opinion, most people would be far more successful compounding their way to riches than they would be trying to time the markets.

What do I do? I use both methods. I have compounded muni bond income for years. I also time the market by buying stocks during bull markets and selling out during bear markets.

How do the two methods compare? Compounding the bonds is boring. But believe me, it gets more interesting as the assets add up. And over the years those assets will add up.

Timing the bull and bear markets is a lot more interesting, it takes up a lot more time, and it most definitely stirs up a lot more anxiety and sweat.

Nevertheless, I use both methods, and I have no quarrel with either. However, and I make this stipulation, if you are young (and I mean under 35 years of age) I strongly advise you to start with the compounding methods. That's the guaranteed way to accumulate money, and it's a great way to learn patience and market discipline.

In other words, if you're "young" you already own the most precious commodity an investor can have -- time. After that, if you wish, use timing. That's the best advice I can offer anyone (may I suggest that older subscribers show this section to their children).

NOTES & QUOTES: Up to now it's been, "Well, those foreigners may be buying up America, but we're a 71% service economy now, and nobody's going to run to Japan to get a haircut or buy a hamburger." Mmmm, good thinking, but foreigners aren't following the script. For instance, the Japanese now own 13% of Shearson Lehman Hutton, 13% of Goldman Sachs, and 18% of PaineWebber. They also own six of California's 12 leading banks. So I'd say that if you're in the service industry, it might be worthwhile to start studying a foreign language.

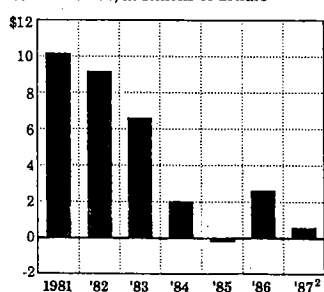
This little chart shows what's happening. Except it doesn't show first quarter 1988, when our service balance went negative for the first time in 50 years. In other words, the money we pay to foreigners for loans and investments is now exceeding what we take in. And the situation is compounding as foreigners take in more and more dollars and buy increasingly into US assets.

Remember how American industry prayed for a weak dollar so we could "become competitive again." Well, we've got the weak dollar and the "buying up of America" is one of the results. Americans are complaining about Toyotas in every garage. How about a Bank of Japan on every corner? The Japanese, by the way, now control 37% of the world's bank lending. And their banks are very, very competitive, often offering loans below the US level. The trend tells me that the Japanese have the ability to take over as No. 1 in world service. They have the assets, the will, a skilled population, a world-class communications system, and a culture which has a history of pleasing.

This year's buzz-word in the advisory business seems to be "market timer." Suddenly, everyone is a hot (winning) market timer. There's the top timer for the last five years, the leading timer since 1985, the winning timer for the last year. One service is currently advertising (no kidding) that he's "the # 1 market timer for first quarter '88." What's next, last week's top timer or yesterday's top timer? I wonder how many of the top timers actually got out before the crash (of course, they ALL claim they did).

The Shrinking Surplus In Business Services

U.S. balance on business-related¹ services trade, in billions of dollars



¹ Excludes government transactions and investment income.

² Annualized, based on first nine months.

Source: Commerce Department

Notable Quotes: From "Mr Republican," Barry Goldwater -- "The greatest threat to the US is internal, not external. The national debt approaches everything we have. And we're in a welfare state. Fifty percent takes care of the other 50 percent. We'll either go bankrupt or wind up with a dictatorship. The question is, will we ever have a Congress with enough guts to change things? I don't think so." From last week's *New Yorker* profile piece on Goldwater.

The Texas real estate fiasco is calculated to cost the various government agencies between \$4 and \$7 billion in terms of bailouts and insurance. One problem is that the FSLIC is now broke and is nearly \$12 billion under water, as this chart from the April 19 NY Times shows. The shortfall is going to add a bunch to the federal deficit. And I ask myself, "What happens when the next recession hits and things really go bad?"

James Reston was head of the NY Times Washington Bureau for many years. Few people know Washington as he does. Here's what he says about Washington: "Most of our government is run most of the time by men and women who are unelected, unconcerned, and unavailable." He cites 332 public relations people who report to the White House, and states, "This administration spends \$2 billion in public funds on P.R. When I went to Capitol Hill in 1947 there were 2,030 staff people. Today there are 18,639."

Rambo III is nearing release, but the timing could be a big problem. In the movie Stallone takes on the Soviets in Afghanistan. But in the real world the Russians are preparing to leave Afghanistan. Moreover, the word is that the public may be tiring of Rambo (particularly after the realism of Platoon and Full Metal Jacket). Rambo III was budgeted for \$30 million, but it's supposed to have cost more than \$50 million.

Does Lovastatin, Merck's new cholesterol-lowering drug, work? Here's my experience. I have always had high cholesterol and no amount of diet ever made the slightest difference (yes, I was on the Pritikin diet). My cholesterol count was always 350 or higher. A year ago I went on Lovastatin (Merck's new drug) plus Cholestid (another cholesterol-lowering drug that can be used in conjunction with Lovastatin). At last count my cholesterol had dropped to 165. Of course, I continue on a low-fat, high-fiber diet, but all I can say is "Thank you, Merck."

The long-predicted "cashless society" has proved to be a figment of economists' imaginations. According to the Federal Reserve Bank of San Francisco, "currency is becoming increasingly popular as a means of payment. The dollar volume of currency outstanding in the hands of the public has been growing for a long time. In keeping with this trend, currency grew from \$148 billion in 1983 to \$200 billion in 1987, a 35% increase." Why does the public love cash? One reason -- cash transactions avoid fat bank charges for checks. Second big reason: cash transactions circumvent the tax man. Nuff said.

How do you stop inflation? These wise words from Warren Buffet: "I could eliminate inflation or reduce it very easily, if you had a Constitutional Amendment that said that no congressman or senator was eligible for re-election in a year in which the consumer price index increased more than 3%. You would change the priorities. It's simply a matter of what your priorities are ..."

According to the World Health Organization, 88,000 people around the world have been officially diagnosed as having AIDS, but the WHO thinks "the more accurate number is closer to 150,000." That's a real plague but its minuscule compared to statistics on the dreaded Black Death (Bubonic plague). The Black Death struck in three ghastly sweeps. The first hit in the Mediterranean area in 541AD and killed an estimated 40 million people. The second pandemic hit in 1347 in Sicily. By 1352 the plague had killed 25 million people. The third pandemic struck in 1855 in Yunan Province of China and spread slowly east. By 1894 the plague hit Hong Kong where it killed 10,000 people. On June 2, 1898 Dr. Paul-Louis Simmonds discovered the deadly rat-to-flea-to-man

basis of the plague. It was the beginning of the end for the Black Death. Vestiges of the plague still exist today, carried mostly by rats, squirrels or rabbits to fleas and then to man (there are 2,400 known species of fleas, of which 120 can carry the bacillus of the Black Death).

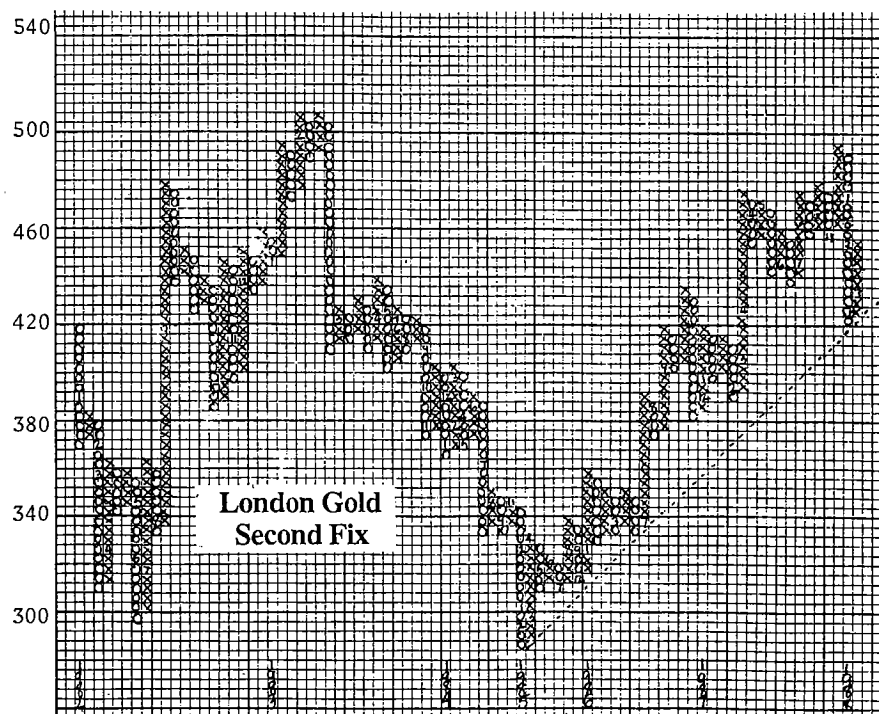
GOLD: There are two bills, one in the Senate sponsored by Cranston (D., Calif.) and one in the House sponsored by Dellums (D., Calif.) The bills would, among other things, make it unlawful for US citizens "to hold any investment in South Africa". I don't know whether either of these bills will go through Congress or if they do whether they would be vetoed, but I think subscribers should definitely take note of these bills.

As subscribers know, I have not recommended the S. African golds in years (although I used to). I have said repeatedly that I do not like the political situation in S. Africa. If there were any doubts in my mind about the wisdom of Americans owning S. African shares, the bills in Congress have eliminated those doubts. My advice: Do not buy S. African gold shares. If you do own these shares, I would sell them.

This point & figure chart shows a most interesting pattern which, as I see it, is assuming the form of a massive base. Note how, on the recent decline, gold held above its rising (bullish) trendline.

A breakdown in gold would come at a spot price of 416, but that doesn't seem likely now. An upside breakout would come at spot 496. If I had to bet, I'd bet on 496. If gold did hit 496, the next target would be 500, then a full upside breakout target at 512. I would say that gold at 512 would be saying some very sad things about the dollar, about the bear market, and about America's future.

Gold hasn't done much since the 1983 highs, but lately the price of diamonds has taken off. DeBeers raised the price of the rough (i.e., unpolished diamonds) 10% last October and another 13.5% last week. The Japanese are gobbling up all over-one-carat stones and the word in the industry is that investment quality diamonds are HOT (as, of course, are collectibles and art). My feeling is that wealthy people the world over are diversifying, not into stocks, but into precious stones, art and collectibles. These areas are all inflating wildly. I wonder how long it will be until gold follows. (As mentioned in these Letters some months ago, I have been a buyer of diamonds.)



LATE NOTES: Late last week yields on the long Treasury bonds broke out above the 9.25% mark. This is strong medicine for the stock market where the dividend yield for the Dow is a paltry 3.45%. In fact, dividing total Dow earnings (133.05) by Dow price gives an "earnings yield" of merely 6.5%. In other words, the bond yield of 9.25% is actually 2.75% higher than the earnings yield (not the dividend yield) on the Dow. Normally, the two should be about equal.

To Wall Street's pain and consternation, volume on the Exchanges is shrinking. Nevertheless, this is typical of action for a bear market. I don't think Wall Street (up to now) has grasped the extent to which the public has been traumatized by history's greatest crash. My DowPow index shows how poor and generally unprofitable the rebound from the crash has been, but I think the public feels it in its collective wallet. Thus, any "hot action" we have seen since the crash has taken place in the merger-an-acquisition stocks and in the auction houses of London and New York (areas where the public has not been active).

The stubbornness with which the stock market has resisted the fairly good economic and business news is almost startling. If ever the market was "marching to a different drum" this would appear to be that time. As subscribers know, the drum I believe this market is listening to is the one that is beating to the rhythm of 1989 and the post-election period. At that time Dukakis or Bush (or anyone else who might be elected) will have to face major problems, the least of which will be the trade and budget deficits plus the precarious situation in the banking and savings and loan industries.

The US is not alone. These charts (courtesy of *Investor's Daily*) show that major stock markets around the world are also dealing with the post-crash syndrome. Never before have the world's economies and stock markets been so intimately linked together. The US may have its own unique problems, but it is still "happy sales territory" for the rest of the world. If, for instance, American consumers stop buying who will Korea and Hong Kong and Japan sell to? Thus the US market is still the barometer of the health of the world.

